THE URBAN INSTITUTE

MEMORANDUM

TO: Fred Van Antwerp

FROM: George Peterson

SUBJECT: Impediments to Signing Program Agreement

DATE: April 3, 1994

Under the terms of RFS #85, the Urban Insfitute is required to prepare a memorandum summarizing the factors impeding signing of the Program Agreement, if the Agreement has not been signed by April 1, 1994. This memorandum fuWills those requirements.

Overall Assessment

Given the recent involvement of the Ambassador and the Minister of Finance in moving the Program Agreement forward, I believe there is a very high probability that the Agreement will be signed within the next six weeks. In fact, if the Agreement is not signed by the end of May, all parties are likely to begin to look seriously at alternative ways to supply credit to the municipal infrastructure sector.

Obstacles to Date

In my judgment, there are both underlying factors and institutional reasons explaining why the Agreement has not yet been **signed.**

1. Narrowing of the interest rate differential between U.S. and Czech markets. When this program was first discussed, U.S. long-term interest rates were in the range of 7 to 7.5% while Czech loans to municipalities of 4-5 year terms were being made at rates of 16-18%. Consequently, even after taking into account foreign exchange risk, there was a wide cost advantage of US funds, which made it possible to borrow on the US market and simultaneously bring down the cost of funds to municipal governments, lengthen the average loan period, and cover generous costs of administration on the part of Czech intermediary institutions.

U.S. interest rates have now begun to rise steeply. The common projection is that they will continue to rise for some period. At the same time, domestic lending rates on the Czech market have begun to fall, especially for loans to municipalities, which have been determined by the Czech National Bank to involve low credit risk.

The consequence of these two trends is that the cost-savings margin obtainable by borrowing on the US market has declined sharply. Therefore, the attractiveness of the HG loan to Czech parties has declined. In particular, it now appears that for the on-lending system to break even, the intermediary institution will have to accept lower administrative and other charges than the Czech and Moravian Guaranty and Development Bank has been anticipating.

I do not regard these developments as fatal, by any means. The administrative costs proposed by CMZRB have been excessive. The new market realities will merely force them to forgo some of the monopolistic charges that they were hoping to be able to impose.

The direct involvement of the Minister of Finance has made clear that the Government has a political stake in making the municipal lending system succeed. It has also confirmed municipalities' expectations that they will have access to relatively low-cost capital, in the range of 12%, implying that most of the cost savings will have to be absorbed by the financial intermediary that is established.

2. Competence and motivation of the Czech and Moravian Guaranty and Development Bank. The Ministry of Finance determined that the HG Program should be channeled through CMZRB. We now have evidence that: (a) CMZRB is not a well-managed or well-focused organization. A large part of the delay that we have encountered is a result simply of CMZRB's inability to identify staff who will be responsible for this program or to move forward systematically in dealings with the Ministry of Finance, commercial banks or others. (b) CMZRB sees this program as an opportunity to enlarge its domain but to do so at a substantial profit. CMZRB has not been willing to commit its expectations about administrative fees, reserve funds to offset risks etc. to writing, but it is manifest that it now wants fees far above the levels that were initially discussed, at a time when CMZRB was competing with other institutions to house the program. CMZRB's unwillingness to enter into an agreement that reduces its fee structure is one important element of the current delay.

The implications of this last observation are twofold. First, the Program should anticipate a much stronger dose of technical assistance to CM ZRB and the financial intermediary it establishes than originally contemplated. We now know that CMZRB does not have many of the skills needed to make the intermediary function successfully. This area should become a top priority for external assistance. Second, although technical discussions can help identify the levels of risk in the program and quantify some of the costs that reasonably must be incurred in protecting against these **risks,** by far the most effective influence on CMZRB is pressure from the Ministry of Finance to finalize the program and deliver the promised benefits to municipalities. The timing of the fall elections adds urgency to getting the program started. If one of the payoffs to launching the Program is to be able to announce actual lending commitments before the elections, the Program Agreement must be signed in the very near future.